Agency Mortgage-Backed Securities

Mortgage Refis Rise on Lower Rates

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Prepayment risk is contained for now, but the near-term technical picture remains challenging.

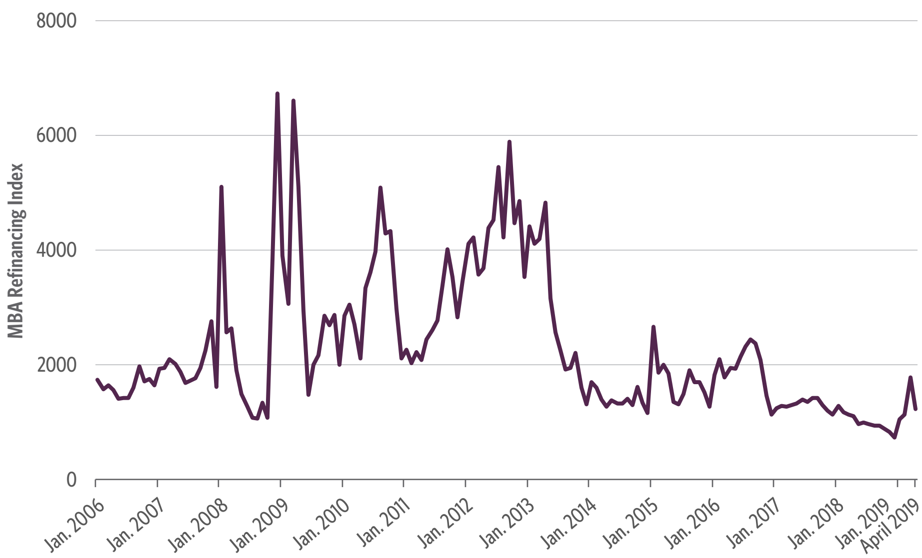
Agency MBS underperformed major spread sectors in the first quarter due to lower rates, a flatter 2s/10s yield curve, and lower implied interest rate volatility. The Bloomberg Barclays U.S. MBS index posted a 2.2 percent total return for the quarter. Option-adjusted spreads were unchanged over the quarter while nominal spreads tightened.

Prepayment speeds have finally started to rise for residential MBS with the move lower in mortgage rates this year. The MBA refinancing index, a leading indicator of prepayment volumes, has risen sharply (see chart, top right) and driven our focus back to mortgage refinancing risk. While data for the next few months will likely show increases in prepayment speeds, we view overall risk as being contained at the current level of rates. The majority of mortgages were originated at lower rates, and only 25 percent of them have enough rate incentive right now to refinance (see chart, bottom right). Mortgage rates would need to move lower by more than 20 basis points for the majority of mortgages to be in the "refinance zone." Additionally, most mortgages were originated before 2018 and have seen lower rates multiple times and have not prepaid, indicating they may not be as responsive at these mortgage rates. Therefore, we view refinancing risk to be limited to mortgages originated more recently at higher rates.

Valuations look reasonable, although residential MBS has moved closer to the tight end of the range. Low interest rate volatility has supported the sector this year, but we view this environment as unsustainable. The near-term technical picture remains challenging due the ongoing decline in Fed holdings and growing supply from the seasonally stronger housing market. We continue to favor investments where either the collateral or structure offers some cash flow stability at reasonable spreads. Accordingly, we find select subsectors attractively priced in the current environment, including longer-maturity Agency multifamily securities, better call-protected pools, and some collateralized mortgage obligation structures. We expect these investments to perform well in scenarios where interest rate volatility rises, interest rates decline sharply, or the Fed continues down the path of reducing its MBS holdings.

GUGGENHEIM

The MBA Refinancing Index Rose Sharply in Q1



Source: Guggenheim Investments, Credit Suisse, Mortgage Bankers Association. Data as of 6.10.2019.

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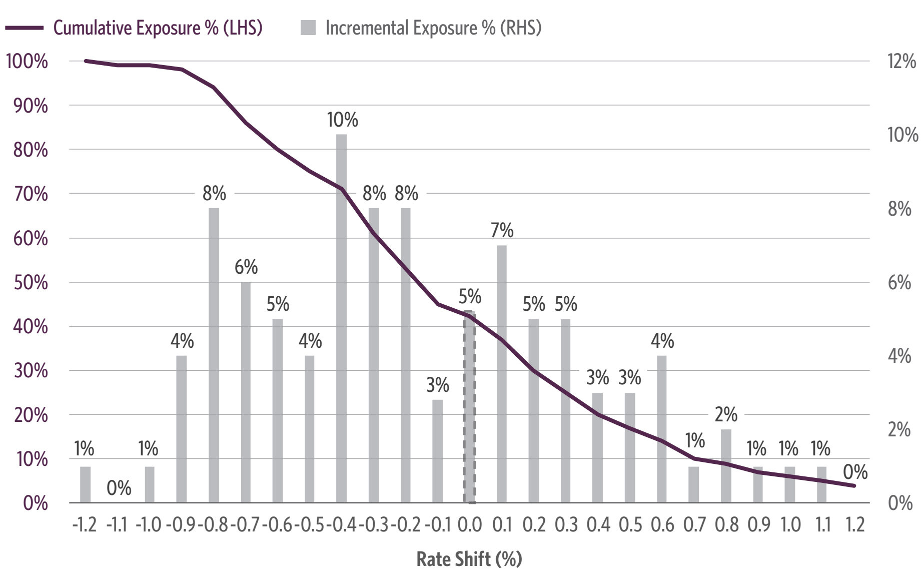
Mortgage Refinancing Exposure in Rate Shifts



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